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AGENDA ITEM 9e

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Consultant Review of Internal Enhanced Index Program
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Information
- IV. ANALYSIS:**

The annual Wilshire Associates review of the CalPERS internally managed enhanced index portfolio is shown in Attachment 1. Staff very much appreciates Mr. Junkin's comments with respect to the quality of the personnel, investment process and support systems, and agrees with his conclusions regarding the ongoing efficacy of the program.

Staff recognizes the concerns raised relating to key person risk, the QuantTrade relationship, and the trading process for this portfolio; however, there are plans in place to address those concerns. Staff also acknowledges the recent deterioration in performance but shares Wilshire's optimism that this is due to a short-term deleveraging effect in the quantitative equity management industry and that the portfolio's style will pay off in the long term.

Key Person Risk

The Portfolio Manager of this portfolio is crucial to this strategy and, due to various logistical considerations (location, complexity of model) there truly is no suitable back-up. However, there is a contingency plan in place should the Portfolio Manager leave employment with CalPERS. CalPERS' large domestic

equity index fund, which has the same benchmark, would absorb the assets into the index fund, thereby freeing up risk budget to allow re-deployment of the capital and the seeking of other sources of alpha at a later date.

Relationship with QuantTrade

Staff is happy to see Wilshire's recognition of the value of the services that QuantTrade provides to CalPERS and is in agreement. Staff concurs that potentially paying QuantTrade a fixed research fee should be explored, as this would ensure stability in QuantTrade's revenue stream and thereby ensure consistency in the service delivery to CalPERS. When exploring this, staff will take into account the cost of execution of the strategy (commissions) and determine if the commissions to be paid can be leveraged to pay QuantTrade for their research, which is a common industry practice as mentioned by Mr. Junkin.

Trading Process

Over the past two years, internal equity staff has been working on consolidating internal equity trading activity with one centralized trading team as part of the movement toward functionalization of the Global Equity program. The first step was to consolidate trading of the majority of the domestic strategies with that of the international strategies. Next, staff revamped the process on a global basis for broker selection, evaluation, and allocation, as was presented to the Investment Committee in October 2008. This process included engagement with Mosaic to aid staff in seeking out emerging firms for brokerage activity. Most recently, trading for the flagship domestic equity index and micro-cap funds, which are both internally-managed, has been merged into this program to be effectuated by the central trading team.

While the trading of the internally managed enhanced index portfolio has been effectuated with the same systems and compliance protocols as the other internal strategies, a logical next step would be to explore combining it with the rest of the strategies; thereby completing the consolidation of internal equity trading with one central trade desk. Further, it would provide economies of scale in this mechanism, would create one consistent message in facing the brokerage community, and would leverage and further promote the process built by staff and Mosaic in terms of broker selection, evaluation and allocation.

V. STRATEGIC PLAN:

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Cost impact of the potential changes described above would be minimal. Before implementing a fixed payment to QuantTrade, staff would ensure the cost would be offset by a reduction in commission charges. Consolidation of trading activity would be effectuated utilizing existing resources and would actually leverage such.

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